

## Memorandum

Agenda Date: June 16, 2000

Item Numbers:

Company Name: Waste Management of Washington, Inc., formerly known as Washington Waste Hauling and Recycling, Inc., d/b/a the following:

<b>Dockets:</b>	<b>TG-000475</b> Olson's Sanitation Service, G-103	<b>(0.8%)</b>
	<b>TG-000476</b> Valley Garbage Service, G-1	<b>(0.8%)</b>
	<b>TG-000477</b> Brem-Air Disposal, G-38	<b>(0.8%)</b>
	<b>TG-000478</b> North Sound Sanitation, G-38	<b>(0.8%)</b>
	<b>TG-000479</b> WM-Northwest, G-237	<b>(0.8%)</b>
	<b>TG-000480</b> WM-Seattle, Tariff 18, G-237	<b>(0.8%)</b>
	<b>TG-000481</b> WM-Seattle, Tariff 5, G-237	<b>(0.8%)</b>
	<b>TG-000482</b> WM-Rainier, G-237	<b>(0.8%)</b>
	<b>TG-000483</b> RST Disposal, G-237	<b>(0.8%)</b>
	<b>TG-000484</b> Nick Raffo Garbage Co., G-237	<b>(0.8%)</b>
	<b>TG-000485</b> WM-Sno-King, G-237	<b>(0.8%)</b>
	<b>TG-000486</b> North Cascade Disposal, G-237	<b>(0.8%)</b>
	<b>TG-000487</b> Stanwood-Camano Disposal, G-237	<b>(0.8%)</b>
	<b>TG-000488</b> Rural Skagit Sanitation, G-237	<b>(0.8%)</b>
	<b>TG-000489</b> WM-Spokane, G-237	<b>(0.8%)</b>
	<b>TG-000490</b> Western Refuse Co., G-237	<b>(0.8%)</b>
	<b>TG-000491</b> WM of Kennewick, G-237	<b>(0.8%)</b>
	<b>TG-000492</b> WM of Ellensburg, Tariff 8, G-237	<b>(0.8%)</b>
	<b>TG-000493</b> WM of Ellensburg, Tariff 5, G-237	<b>(0.8%)</b>
	<b>TG-000494</b> WM of Greater Wenatchee, G-237	<b>(0.8%)</b>

Company Name: Allied Waste Industries, Inc., operating various companies as follows:

<b>Dockets:</b>	<b>TG-000751</b> Rabanco Ltd. & Rabanco Recycling, Inc. d/b/a Eastside Disposal, G-12	<b>(0.38%)</b>
	<b>TG-000752</b> Seattle Disposal Company, G-124	<b>(0.21%)</b>
	<b>TG-000753</b> Northwest Waste Industries, Inc. d/b/a Emerald City Disposal, G-235	<b>(0.21%)</b>
	<b>TG-000754</b> Rabanco Connections International, Inc. d/b/a Issaquah Division, G-41	<b>(0.64%)</b>
	<b>TG-000755</b> Rabanco Connections International, Inc., Maltby Division, G-41	<b>(1.04%)</b>
	<b>TG-000756</b> Rabanco Ltd. & Rabanco Recycling, Inc. d/b/a SeaTac Disposal, G-12	<b>(0.55%)</b>
	<b>TG-000757</b> Fiorito Enterprises, Inc., & Rabanco Companies d/b/a Kent Meridian Disposal, G-60	<b>(0.62%)</b>

Staff: Gene Eckhardt, Transportation Program Staff  
Bob Colbo, Transportation Program Staff

**RECOMMENDATION:**

Staff recommends the Commission issue a Complaint and Order Suspending the fuel surcharge supplements filed by:

- Waste Management of Washington, Inc., in Dockets TG-000475 through TG-000494, and
- Allied Waste Industries, Inc., companies in Dockets TG-000751 through TG-000757.

**BACKGROUND:** The Commission approved fuel surcharge increases for solid waste companies in the early 1970s when the OPEC Cartel restricted oil production and fuel prices increased sharply, and again in 1990 when the Gulf War caused fuel prices to spike. The Interstate Commerce Commission and other state regulatory Commissions also approved fuel surcharges for passenger and freight transportation companies during those periods.

1990 Methodology - In 1990, the Commission sent "Commission-approved procedures" to the haulers to use in filing fuel surcharges. (Appendix No. 1) Those procedures included a threshold materiality test that required a revenue impact to the hauler of at least 1.0% on annual revenues. No company contested the 1990 "Commission-approved procedures."

Review of the 1990 fuel surcharge filings show:

- fuel prices increased about 40%
- fuel expense was about 2.5% of revenue (less pass-through disposal fees and City of Seattle Tax (22%))
- approved surcharges were about 1.0% of revenue
- the surcharges remained in effect for two to four months

2000 Methodology - As fuel prices began to creep up in early 2000, haulers asked Staff to send them guidelines to use in filing fuel surcharges. Staff discussed the 1990 "Commission-approved procedures" and concluded changes were appropriate. Staff kept the 1% of revenue threshold as a materiality test, changed the Total Company Revenue calculation to include pass-through disposal fees and taxes, and proposed a Base Fuel Price using the January 2000 average fuel price instead of the previous calendar year average fuel price that had been used in the 1990 "Commission-approved procedures." Staff sent its 2000 Guidelines first to the airporter and bus companies and then to the solid waste industry. No solid waste company has qualified for a fuel surcharge using the Staff's 2000 Guidelines.

Waste Management Tariff Filings

On March 31, 2000, Waste Management of Washington, Inc., (WM) filed twenty fuel surcharge supplements proposing to increase rates 0.80 percent for each of the above operating companies. Each filing was accompanied by a request to make the supplements effective April 13, 2000, on less-than-statutory notice (LSN). The Commission took no action on the LSN requests at the April 12, 2000, Open Meeting.

WM used its own method to determine whether it needed a fuel surcharge. (Appendix No. 6)

- Fuel Price Increase is calculated using 1999 average fuel price and invoice prices for March 30, 2000, and varied between 15.9% (Western Refuse Co.) and 48.6% (Rural Skagit Sanitation).
- Net Revenue is calculated by deducting total (not just pass-through) disposal fees, commodity sales, and gross revenue taxes.
- Historical fuel expense as a percent of Net Revenue varied between 3.5% (Valley Garbage Service and WM-Spokane) and 11.2% (Olson's Sanitation Service).
- WM's threshold is 1.0% of Net Revenue. Increased cost of fuel as a percent of Net Revenue varied between 0.9% (Valley Garbage Service and WM-Spokane; Western Refuse Co.) and 3.1% (Olson's Sanitation Service)
- Using Total Company data, WM calculated the average increased fuel cost as 1.5% of Net Revenue.
- WM calculated a company-wide fuel surcharge of 0.8% using Total Company data to compare the increased cost of fuel to Total Collection Revenue minus taxes and commodity revenues, but leaving in total disposal fees.

Staff thinks deducting total disposal fees and gross revenue taxes to calculate Net Revenue for the 1.0% test distorts the financial characteristics of the solid waste industry. Those deductions are inconsistent with the Lurito-Gallagher Model that the Commission uses to establish revenue requirements and operating ratios for solid waste collection companies. The Lurito-Gallagher Model uses total revenues and total expenses, including disposal fees and gross revenue taxes.

Staff met with WM to discuss the differences in the surcharge methodologies, but we did not reach agreement. WM agreed to postpone the effective dates of all its tariffs to allow time for the Staff to convene an industry-wide stakeholder group to discuss fuel surcharges. WM's tariffs are now scheduled to become effective July 1, 2000.

#### Allied Waste Industries Tariff Filings

On May 16, 2000, Allied Waste Industries, Inc., (Allied) filed seven fuel surcharge supplements proposing to increase rates between 0.21% and 1.04% effective July 1, 2000. Each filing was accompanied by a request to make the supplements effective June 1, 2000, on less-than-statutory notice (LSN). The Commission took no action on the LSN requests at the May 31, 2000, Open Meeting.

Allied used its own method to determine whether it needed a fuel surcharge. (Appendix No. 6)

- Fuel Price Increase is calculated using 1999 average fuel price and invoice prices between March 24, 2000, and March 31, 2000.
- Allied did not use any minimum threshold measurement.
- Fuel cost increase as a percent of revenue, including city gross revenue taxes, varied from 0.21% to 1.04%.
- The surcharge applies to city gross revenue taxes.

Staff strongly believes the Commission should use some minimum threshold test (Staff's 2000 Guidelines use 1.0% of revenue) to determine whether the changes are material to the company's operations. We are also concerned that Allied used fuel data that is at least one month old at the time of its filings. Our data indicates that fuel prices peaked during the week ending March 20, 2000, and prices have decreased since then.

Allied has not provided documentation supporting its summary calculations and Staff has not verified any of the data.

#### Couse Tariff Filing

On June 5, 2000, Couse's Sanitation & Recycle, Inc., (Couse) proposed a fourth methodology in response to Staff's notice of a stakeholder meeting to discuss fuel surcharges. On June 12, 2000, Couse filed a proposed fuel surcharge supplement, using its own methodology, with a request that the filing become effective July 1, 2000, on less-than-statutory notice. The Commission will consider that filing at the June 28 Open Meeting. The Couse Methodology is attached as Appendix No. 7.

#### Stakeholder Meeting

To bring stakeholders together as quickly as possible to discuss the fuel surcharge issue, Staff used the ongoing solid waste rulemaking to convene a meeting June 6, 2000. Staff advised the participants that the Commission would consider the pending fuel surcharge filings at the June 16, 2000, Open Meeting. We also discussed possible outcomes of the Open Meeting process and how to best move forward. In considering whether the Commission should resolve the fuel surcharge issue using a Policy Statement, a declaratory order, an order issued in a rate case, or by rule, haulers unanimously stated they wanted the Commission to resolve this issue by setting its decision in rule. Staff may continue to explore fuel surcharges in the solid waste rulemaking. However, if the Commission suspends these tariff filings and the haulers choose to go to hearing, there is a risk of ex parte contact.

Staff posed the question, "Do companies need more revenue?" The companies stated that they need and want an increase. Further discussion indicated that haulers not only want a fuel surcharge, they want it to last long enough to recover all additional expenses incurred. Also, the haulers want the methodology to be as quick as possible, involve as little justification or analysis on the part of the companies as possible, and include the least amount of customer notice possible.

Staff suggested three options to deal with changes in fuel prices:

1. No surcharge - Rate case only - This option would require haulers to demonstrate a need for additional revenue with an earnings test, similar to a rate case. The industry opposes this option as unresponsive, burdensome, and too costly for smaller companies.

2. Deferred Accounting - This is the only option that will ensure a hauler recovers all of its fuel costs. The discussion on this option was very short. Except for one hauler, everyone agreed that deferred accounting requires a lot of effort and the amount of money involved was probably not worth the effort. That hauler stated that deferred accounting works and it could be an effective way to deal with fuel price changes. A second hauler stated that deferred accounting could work, but should be adopted only as a last resort – if another simpler, more responsive, less intrusive methodology could not be implemented.

3. Surcharge - Industry representatives unanimously agreed that a surcharge was the appropriate method to address fuel price changes. The industry also unanimously rejected Staff's 2000 Guidelines as too burdensome, requiring too much analysis and justification, too costly for smaller companies, non-responsive to price spikes, and creating uneven playing fields not only among solid waste companies, but between solid waste companies and other regulated industries (buses). Staff advised the haulers that Staff was not advocating the methodology set forth in the Staff's 2000 Guidelines, but that we were there to consider the three options identified in the agenda and other options identified during the stakeholder meeting. A participant remarked that a small hauler had spent 35 hours working on the Staff's 2000 Guidelines, but still could not understand it and gave up. Staff is confused by this statement. We attempted to design this form to make it easy to complete. Referring to the Staff's 2000 Guidelines (Appendix No. 2), the form uses just four numbers: 1999 Total Company Revenue (1999 Annual Report), 1999 Fuel Expense (Annual Report), January 2000 Average Fuel Price, and Current Fuel Price.

The stakeholder group discussed that, if the Commission approves some type of surcharge methodology, the approved methodology needs to include some type of "threshold" or "trigger" that would automatically determine when a hauler could file a fuel surcharge. The group identified three different approaches. The Commission could consider the change in the price of fuel, the change in a company's operating results, the change in a customer's bill, or any combination.

- Fuel Price Change - Haulers thought this method was more equitable and eliminated different treatment due to variation in disposal fees, taxes, rural operations, etc.
- Effect on Company - Staff used this method to gauge whether the fuel price changes were material to the Company. Staff reviewed the 1% annual revenue threshold used in the 1990 "Commission-approved procedures" and concluded it was a reasonable measure of material impact to the hauler. A 1% annual revenue

impact means the average impact to the Company is 0.083% each month. (Appendix No. 3) Haulers oppose this approach because they believe it does not take into account the difference between companies in the amount of disposal fees paid, taxes paid, and, by including disposal fees and taxes in the revenue calculation, it treats solid waste haulers different from airporters and bus operators.

- Effect on Customer - This method would trigger a surcharge when the increase in fuel prices would change the customer's bill by certain amount. For example, the Commission could set an amount, such as \$.05 or \$.25, as the minimum amount that a typical residential customer's bill must change before a surcharge could be implemented. Haulers oppose this approach because they believe it does not take into account the difference between companies in the amount of disposal fees paid, taxes paid, and it treats solid waste haulers different from airporters and bus operators.

Although haulers repeatedly stated that the surcharge ought to be very simple to calculate, they did not reach consensus on a proposed methodology. However, the stakeholders did generally like a proposal, that Staff will call the "Workshop" methodology, that:

- evaluates the need for a fuel surcharge every three months
- is "triggered" by a change in fuel price only
- allows automatic increases or decreases anytime fuel prices rise or fall by more than 20% compared to a base fuel price
- would increase (decrease) rates by only the amount that exceeds the 20% increase (decrease)
- uses the average cost of fuel for calendar year 1999 as the base fuel price
- uses data from a fuel price index as the sole justification required to demonstrate a fuel price increase (some haulers thought they should use company-specific fuel prices)
- could apply statewide for all companies, company-wide for all operating entities, or for each separate operating entity (haulers seemed equally divided on this issue)
- requires no customer notice or a single line on bills that states, "The WUTC has approved a fuel surcharge of xx%."
- would remain in effect for three months

Given the number of variables, there are many possible iterations of this model. In summary, there was no meeting of the minds on a single methodology to implement a fuel surcharge.

Both haulers and Staff would like the fuel surcharge issue resolved industry-wide and whatever the Commission adopts to apply on a going-forward basis, so we don't go through this process again.

## **DISCUSSION**

Managers for the solid waste collection companies have a fiduciary duty to maximize shareholder benefit. As fuel prices increase, companies pay more dollars for fuel. That hurts cash flow. Every additional dollar paid for higher fuel is a dollar less for the bottom line and shareholders.

We all know the price of fuel has increased in the last six months. However, Staff believes that alone is not enough to justify a rate increase. In analyzing rate increase applications, the Staff asks "Does the company need more revenue to recover expenses and earn a reasonable return on its investment?" or, in other words, "Should customers pay more for the service they receive?"

### **Earnings Test**

A rate case evaluates a company's operations to ensure the company recovers appropriate expenses and earns a fair return on investment. The Commission uses the Lurito-Gallagher Model to determine a company's revenue requirement and operating ratio. The Lurito-Gallagher Model uses a company's operating expenses, investment and capital structure as critical inputs. When those inputs change, the resulting revenue requirement and operating ratio also change. The revenue requirement determines the rates customers must pay for their service. The relationship of expenses to revenue is expressed as an operating ratio. At the conclusion of a rate case, we have a high degree of confidence that the rates are fair, just, reasonable and sufficient.

However, operating expenses, investment, capital structure, number of customers, etc. change almost immediately. Consider replacing an old collection truck with a new collection truck. Depreciation expense will increase, but the new truck would likely be more fuel efficient, it should require less maintenance, it may require less labor to operate, and it may allow more efficient collection of garbage, curbside recycling or yardwaste. The purchase would also change the company's investment and capital structure. That means the company's revenue requirement and operating ratio will change. Some external changes, such as customer growth (both regulated and non-regulated), decrease average cost per customer. Mergers should lead to greater efficiency and cost savings to the customers, and will likely change the company's capital structure. Investment and capital structure will change over time to reflect any new investments. Any of the many variables can increase or decrease, and the only way to determine whether a company requires additional revenue is to perform an earnings test.

### **Single-Item Rate Increases**

Some cost items are so large, that regulators deal with them separately. In the energy industry, purchased natural gas is a large part of a gas utility's total expense, 40% to 60%. The company has little control over the prices, which can be volatile. The Commission allows the gas utility to use a deferred accounting mechanism to ensure the gas utility will recover its cost to purchase natural gas.

In the solid waste industry, disposal fees vary between 30% and 50% of a solid waste collection company's total cost. RCW 81.77.160 requires the Commission to pass disposal fee changes straight through to the customer without an earnings test to determine whether other expenses have changed and might offset the company's need for additional revenue. Staff only ensures that the rates reflect the appropriate amount of disposal fees.

In April 1997 through 1998, Staff worked with solid waste collection companies in Whatcom County to implement a deferred accounting mechanism for disposal fees. At that time, a new disposal site began operations and started a price war with the only other disposal site. Disposal fees varied wildly for about two years. Deferred accounting ensured that customers benefitted from price decreases and protected haulers from price increases by ensuring the haulers recovered all of their disposal costs.

Occasionally, a company may experience a significant change in a single expense soon after it completes a rate case. If there have been no significant changes in the company's other expenses, investment, capital structure, number of customers served, etc., it may be appropriate for Staff to recommend the Commission approve a single item rate filing. However, Staff needs to assure there have been no changes in other factors that could offset the company's need for an increase. Staff needs to analyze single-item rate filings on a case-by-case basis.

#### Review of Companies Proposing Fuel Surcharges

WM companies have rates based on test year periods that are three to seven years old. (Appendix No. 4) Some of the companies may have experienced growth in the number of customers served. WM merged with USA Waste in July 1998, and that merger ought to create some efficiencies and benefit to ratepayers. The capital structure of the merged companies is very different from WM's capital structure at the time the rates were set. Although recycling rates are reportedly increasing and average waste disposed per customer decreasing, the rates for these companies are based upon the average waste disposed during the test year, and those test years have since been "updated" to pass-through disposal fee increases. WM's 1998 Annual Reports, the most current available, show that five of the eight companies have operating ratios that are better than the operating ratio approved in the last rate case. (Appendix No. 4) The 1999 Annual Reports were due May 1, 2000.

Allied companies have rates based on test periods that are four to five years old. Allied purchased the stock of the Rabanco companies in 1998. The Allied capital structure today is different from the Rabanco companies' capital structures at the time rates were set. Although recycling rates are reportedly increasing and average waste disposed per customer decreasing, the rates for these companies are based upon the average waste disposed during the test year, and those test years have since been "updated" to pass-through disposal fee increases. SeaTac's rates are based on a test year ended June 1996, with an approved operating ratio of 95.69%. SeaTac's 1998 Annual Report, the most recent available, shows an operating ratio of 90.7% and data filed in a pending case shows a 1999 operating ratio of 86.05%. (Appendix No. 5)



#### Data Collection and Analysis

Staff's review of available data on fuel prices provided little insight into fuel price movements and clearly shows there is no reliable method of forecasting fuel prices. The Energy Information Administration (EIA) tracks fuel prices throughout the United States and uses a statistical model to forecast fuel prices. EIA's most recent Short-Term Energy Outlook Report (May 2000) concludes "We expect that diesel fuel prices will decline the rest of the year, but at a slower rate than the projected motor gasoline price decline."

The Oil Price Information Service publishes four fuel indexes for Washington State. The "Seattle" index covers Western Washington from Olympia north to the Canadian border. The Washington Department of General Administration provided Staff with data for Diesel No. 2, low sulphur, back to July 1996. That data show that fuel prices peaked at \$1.5640 for the week ending March 20, 2000, and have declined slowly to \$1.3054 for the week ending June 12, 2000, the most recent data.

<u>Period</u>	<u>Fuel Price</u>	<u>Increase to 1999 Average (\$1.1195)</u>
March 20, 2000	\$1.5640	39.71%
March 2000	\$1.5283	36.52%
1 <sup>st</sup> Quarter 2000	\$1.3828	23.52%

Newspapers and trade journals predict fuel prices exceeding \$2.00 per gallon in the summer and some Midwestern states have already experienced prices higher than \$2.00 per gallon. Individual haulers have not provided historical fuel data to Staff.

#### **CONCLUSION**

Staff concludes that under current conditions, the Commission should require an earnings test before the Commission authorizes any change in rates. Fuel varies between 1.8% and 5.6% of total revenue minus commodity revenue for the companies that filed fuel surcharges. Recent changes in fuel prices have not had a material impact on solid waste collection companies. Staff has not identified a sound statistical approach to develop a fuel surcharge. The question should not be "How can we calculate a rate increase for the haulers?" Staff believes the proper question is "Does the company require additional revenue to recover expenses and earn a reasonable return on investment?" or, from the customer's perspective, "Should the customer pay more?"

Staff recognizes that haulers have different needs, and suggests the Commission should allow each hauler to choose whether or not it will implement deferred accounting for fuel expenses on a going forward basis the next time the company files a rate case.

If the Commissioners conclude that fuel surcharges are appropriate for the solid waste industry, Staff recommends you consider the following factors:

- A surcharge should only be used to address an extraordinary event. The amount of a surcharge will likely vary from month to month, but, in the aggregate, Staff

thinks the surcharges should remain in effect for a short period of time (six to twelve months).

- Require haulers to provide an earnings test that demonstrates a need for additional revenue. An alternative would allow fuel surcharges for only those haulers that have a recent earnings test, such as rates based on a test period no more than two years old.
- Establish a minimum threshold or "trigger" that will determine when a hauler can implement a fuel surcharge. The Commission used 1.0% of revenue in its 1990 "Commission-approved procedures" and Staff included that in its 2000 Guidelines. Alternative approaches could require a minimum increase in the average residential customer's bill (such as \$.05 or \$.25), a minimum change in the price of fuel, or any combination of the three options.
- Match the calculation of the current fuel price to the period of time a surcharge would remain in effect. For example, if the surcharge is intended to remain in effect for three months, then the current price should reflect the average price for fuel over the most current three-month period. A spot price at the end of a three-month period will likely not represent the average price of the period.

Finally, if the Commission approves a fuel surcharge methodology, haulers will need to update their tariff filings and justification to reflect current data.

### **RECOMMENDATION**

Staff recommends the Commission issue a Complaint and Order Suspending the fuel surcharge supplements filed by:

- Waste Management of Washington, Inc., in Dockets TG-000475 through TG-000494, and
- Allied Waste Industries, Inc., companies in Dockets TG-000751 through TG-000757.